Nos. 20375, 20382

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

W. THOMAS DAVIS and ELIZABETH LLOYD DAVIS,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

M. PHILIP DAVIS and CAROLYN L. DAVIS,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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INDEX

CITATIONS

es:

Pag

Statutes:

Miscellaneous:

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (I-R. 28-57) [1/] are not officially reported.

1/ "I-R." and "II-R." references are to volumes I and II of the record on appeal.

JURISDICTION

This petition for review (I-R. 78-85) involves federal income taxes for the taxable year 1953. On June 9, 1961, the Commissioner of Internal Revenue mailed to the taxpayers notices of deficiency, asserting deficiencies in those taxes in the aggregate amount of $160,833.84. (I-R. 10-19, 22-27.) Within ninety days thereafter, on August 30, 1961, the taxpayers filed petitions with the Tax Court for redeterminations of those deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939. (Tax Court Docket Entries; I-R. 1-9.) The decisions of the Tax Court were entered on May 20, 1965. (I-R. 67, 77.) The cases are brought to this Court by a petition for review filed on August 12, 1965 (I-R. 78-85), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred upon this Court by Section 7482 of that Code.

QUESTION PRESENTED

Taxpayers, who held an option to purchase a lemon orchard with an unmatured lemon crop and related assets for a lump-sum price, sold the unmatured crop at the time of their purchase of the orchard. The question presented on this review is whether the Tax Court correctly held that the purchase price was to be apportioned among the acquired assets on the basis of their relative fair market values and that the excess of the price received for the lemon crop over its cost basis constituted taxable gain to taxpayers.

STATUTES INVOLVED

nternal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) General Definition.--"Gross income" includes gains, profits, and income derived * * * from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) Computation of Gain or Loss.--The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain * * *.

* * * *

(26 U.S.C. 1952 ed., Sec. 111.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) Basis (Unadjusted) of Property.--The basis of property shall be the cost of such property * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 113.)

STATEMENT

The taxpayers,[2] W. Thomas Davis and M. Philip Davis, were brothers who resided in California during the period that is here

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2/ Elizabeth Lloyd Davis and Carolyn L. Davis, the taxpayers' wives, were joined as parties only because joint returns were filed.

involved. They had been engaged in agriculture since 1950 and had owned lemon acreage since early 1952. Toward the end of 1952 the taxpayers began negotiations to acquire the assets of the Del Norte Citrus Company, a corporation with operating assets consisting of 428.35 acres of land, 354.26 acres of which were planted with lemon trees of varying ages, and land improvements including irrigation lines, underground tanks, wells, roads, and various buildings and wind machines useful in connection with the operation of a lemon orchard. This property was located on the Oxnard plain in Ventura County, California. Lemon trees in the Oxnard plain area produced lemons throughout the entire year, and at any time of the year lemons in all stages of development are on such trees, including the lemon blossoms and pea-size fruit through mature fruit. It generally takes from eight to ten months for lemons in the Oxnard plain area to mature, and generally the period during the year for harvesting mature fruit is in the months of May, June and July. (I-R. 29-31.)

As a result of taxpayers' negotiations, in late April or early May of 1953 they acquired in the name of Tophil Farms, Inc., a non-operating corporation that was wholly-owned by them, options to buy all of the stock of Del Norte for a total price of $889,615.27. The taxpayers did not have available the $500,000 in cash needed to complete the purchase and planned to raise the cash by using the cash which Del Norte had in the bank and selling certain of the Del Norte assets. The assets of Del Norte which Tom and Phil planned to sell were certain revolving fund certificates which Del Norte owned in various packing

ıouses and the lemons on the trees in the Del Norte orchard. They planned to keep the Del Norte land and improvements, including the orchard, and to operate it as a lemon orchard. At the time when they were negotiating for the purchase of the Del Norte properties, they were aware that lemons were in short supply. (I-R. 30-31.)

Commencing in July, 1953, the taxpayers contacted representatives of a number of companies engaged in the manufacture of lemon products, such as processing juice lemons for production of lemon concentrates and frozen juice, in regard to selling the lemon crop. During the course of verbal negotiations with various representatives of lemon processing companies, taxpayers became aware that a number of processing plants did not have sufficient lemons available to meet the commitments which they had for juice and were anxious to buy the entire crop on the trees of the Del Norte orchard for juice purposes. During the latter part of August or early part of September 1953, the taxpayers came to a verbal agreement with representatives of Golden Citrus Juices, Inc., whereby they agreed to transfer the Del Norte lemon crop to Golden Citrus as soon as they acquired title thereto for $2 per box of merchantable lemons to be picked during the succeeding nine months, with the understanding that a person satisfactory to both parties would subsequently estimate the number of boxes of lemons set on the trees in various stages of development from pea-size up to and including mature fruit. The person selected by Golden Citrus and taxpayers estimated that the lemon crop then set on the trees in various stages of maturity from pea-size to full size, which would be harvested over

a nine-month period, would fill 118,850 field boxes of lemons when harvested. Since there would continuously be lemons picked and freshly setting, this person considered that his estimate would be valid as of any date prior to the end of October, 1953, with respect to the crop then set to be harvested within nine months after the date selected. This estimate was accepted and relied upon by both taxpayers and the representatives of Golden Citrus. The representatives of Golden Citrus calculated that lemons were worth about $2.54 a box net to the grower on the tree in mature condition. They therefore considered that by purchasing lemons on the Del Norte orchard for a total price of $237,700, arrived at by multiplying $2 per box by the estimated harvest of 118,850 boxes, Golden Citrus would make a profit on the lemons themselves as well as maintain a much needed supply of lemons. The oral understanding reached by taxpayers and representatives of Golden Citrus was that Golden Citrus would buy the lemon crop in its condition as then set on the trees of the Del Norte orchard for $237,700 cash, Golden Citrus to take all risk of loss of damage to the crop. The representative of Golden Citrus then secured the approval of its board of directors and principal stockholders to the purchase of the lemons in the Del Norte orchard for cash. (I-R. 31-34.)

In early September, 1953, after discussing among themselves the prospective 1953-1954 lemon crop and the demand for lemons, the taxpayers came to the conclusion that they should have some interest in the profit that Golden Citrus might realize upon the re-sale of the lemons from the Del Norte orchard. They decided that they should

receive whatever profit Golden Citrus made over and above its $5 per ton processing fee upon its re-sale of lemons from the Del Norte Orchard. They presented this proposition to the representatives of Golden Citrus. Because of its desperate need for lemons, Golden Citrus agreed to purchase the Del Norte lemons under this condition but insisted that if it agreed to this condition, there should be inserted into the agreement in return therefor an agreement that taxpayers would guarantee Golden Citrus as a minimum number of boxes of merchantable lemons set on the trees of Del Norte orchard the 118,850 boxes that had been estimated to be on the trees. (I-R. 34-35.)

On September 12, 1953, the taxpayers entered into a written contract with Golden Citrus for sale of the lemon crop. This contract recited that taxpayers were in the process of acquiring all of the stock of Del Norte Citrus Company and that upon acquiring this stock they intended to dissolve Del Norte and to distribute all of its assets to its stockholders and provided that as soon as taxpayers acquired all of the stock of Del Norte they would cause it to dissolve and to distribute its assets to them and that they would then sell to Golden Citrus, and Golden Citrus would buy from them the lemon crop for a total price of $237,700 in cash, plus a sum equal to the net profit, if any, made by Golden Citrus upon the re-sale of the lemon crop. The contract further provided that Golden Citrus was to deposit the sum of $237,700 in cash in an escrow account in which taxpayers were to deposit a bill of sale to the lemon crop in favor of Golden Citrus. As soon as title to the lemon orchard had vested in the

taxpayers, the escrow agent was to deliver the bill of sale to Golden Citrus and to pay the $237,700 in cash to the taxpayers. The taxpayers warranted that there were at least 118,850 field boxes of lemons set in the lemon orchard and that Golden Citrus would be able to pick that number of merchantable lemons from a lemon orchard prior to the close of business, June 30, 1954, and that if for any reason beyond the reasonable control of Golden Citrus, it was unable to pick 118,850 boxes of merchantable lemons from the orchard by that date, it would have the right to continue picking merchantable lemons from th orchard until such time as it had picked 118,850 boxes. Taxpayers agreed to maintain the lemon orchard in good condition and to cultivate fertilize, pest and frost control and otherwise do everything reasonably necessary to maintain a good and healthy production, at their own cost and expense. (I-R. 35-37.)

Under date of September 8, 1953, Tophil Farms, Inc., assigned to taxpayers its option to purchase all the Del Norte stock at a total price of $889,615.27. On September 17, 1953, Golden Citrus deposited $237,700 in the Bank of America escrow account that had been opened by taxpayers. On or about September 22, 1953, taxpayers exercised the options to purchase the Del Norte stock. For the purchase of this stock, taxpayers used, in addition to the $237,700 placed in escro by Golden Citrus, cash that was in the bank account of Del Norte. On the same date Del Norte was dissolved and its assets were distributed to taxpayers. A bill of sale for the lemon crop was delivered to Golden Citrus at the time that the escrow account was closed. (I-R. 38-39.)

By June 30, 1954, the final date that had been specified for the picking of lemons by Golden Citrus, that company had picked over 142,000 field boxes of lemons. However, in settlement of a dispute that arose between taxpayers and Golden Citrus in which Golden Citrus claimed that a part of the crop belonging to it had been pruned off the trees by employees of taxpayers, Golden Citrus was permitted to pick an additional 15,000 boxes of lemons from taxpayers' orchard during 1955 to compensate for the portion of its crop lost by pruning. (I-R. 39-40.)

The provision for profit on the resale of lemons in excess of the $5 processing fee of Golden Citrus being returned to taxpayers did not result in any payment to them since the price of lemons declined and Golden Citrus did not make any profit on resale of the lemons. (I-R. 40.)

On their individual income tax returns for the year 1953 taxpayers allocated to the lemon crop, out of the total cost of the orchard, $237,700, the amount for which the lemon crop had been sold. Accordingly, they recognized no gain or loss on the sale of the lemon crop. The Commissioner determined that the cost allocated by taxpayer to the lemon crop was incorrect and determined deficiencies accordingly. (I-R. 41-44.) The Tax Court rejected taxpayers' contention that the lemon crop was equivalent to cash and held that the total cost of the orchard, less the amount of acquired assets that taxpayers, without objection by the Commissioner, had treated as the equivalent of cash, was to be allocated to the lemon crop and the other

acquired assets, other than those that were treated as the equivalent of cash, in accordance with their relative fair market values. (I-R. 49, 52.) It found that the fair market value of the lemon crop was $212,700 and that the total of the fair market values of the other assets that had been acquired from the Del Norte Citrus Company, other than those that were treated as the equivalent of cash, was $823,300. (I-R. 55.) Allocating $661,537.32, the total purchase price less the amount of acquired assets that were equivalent to cash, between the lemon crop and the other assets it determined that the taxpayers' cost basis in the lemon crop was $136,128, so that the excess of the $237,700 sales price over this cost basis constituted gain to them. (I-R. 55-56.)

SUMMARY OF ARGUMENT

Taxpayers, who held an option to purchase a lemon orchard with an unmatured lemon crop and related assets for a lump-sum price, sold the unmatured lemon crop at the time of their purchase of the orchard and used the proceeds of the sale of the crop as part of the purchase price of the orchard. The Tax Court, applying long established principles of federal income tax law, held that the purchase price was to be apportioned among the acquired assets on the basis of their relative fair market values and that the excess of the price that taxpayers received for the lemon crop over its cost basis to them, as so determined, constituted taxable gain to them. In so holding the Tax Court correctly rejected taxpayers' contention that the cost basis of the lemon crop was its fair market value at the time

f the purchase, so that no gain was to be recognized on the sale of he crop. Taxpayers' argument that because of the uncertainty as to he future profitability of the orchard gain should not be recognized upon the disposition of the lemon crop is in direct conflict ith the annual accounting principle underlying the federal income ax system, which precludes deferring the recognition of gain until he results of the complete venture are known. Taxpayers' alternate rgument that the lemon crop was entitled to a first allocation of cost in the amount of its fair market value as a "cash equivalent" was similarly without merit since the crop was not equivalent to cash. Because the income tax consequences to the seller of the orchard would be worsened materially if the lemon crop was sold separately rather than together with the orchard and the related assets it is apparent that unlike cash or the immediate right to receive cash, the portion of the purchase price attributable to the lemon crop was substantially less than the fair market value of the crop.

With one minor exception, both taxpayers' and the Commissioner's appraisers were in substantial agreement as to the fair market values of the acquired assets. Since the Tax Court's findings as to these values have substantial support in the evidence they are entitled to affirmance.

THE TAX COURT CORRECTLY HELD THAT TAXPAYERS RECOGNIZED GAIN IN THE AMOUNT OF $101,572 UPON THEIR SALE OF THE UNMATURED LEMON CROP

Taxpayers purchased a lemon orchard with an unmatured crop and related assets for a total price of $661,537.32.[3/] At the time of this purchase, taxpayers sold the unmatured lemon crop for $237,700. The Tax Court found that, as of the time of the purchase, the lemon crop had a fair market value of $212,700 and the orchard and related assets had a fair market value of $823,300. It held that the total price paid for these assets, $661,537.32, was to be apportioned among them on the basis of their relative fair market values, which totaled $1,036,000, with the result that $136,128 of the purchase price was allocated to the lemon crop and the difference between the allocated cost and the price received for the crop, $101,572, constituted taxable gain to taxpayers. Taxpayers recognize (Br. 28-29) -- at least implicitly, if not explicitly -- that the annual accounting principle which underlies the federal income tax system (Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365) requires that the price paid for a group of assets be apportioned among the assets and gain or loss recognized upon the disposition of part of the assets during the taxable year, and prevents deferral of the recognition of gain until the total cost of the assets has been recovered (Heiner v. Mellon, 304 U.S.

3/ Taxpayers actually purchased the stock of the corporation owning these assets for a total price of $889,615.27, but immediately thereafter liquidated this corporation. (I-R. 38-39.) Accordingly, the Tax Court treated the $889,615.27 as the price paid for the assets. See Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74, affirmed 187 F. 2d 718 (C.A. 5th), certiorari denied, 342 U.S. 827; United States v. Mattison, 273 F. 2d 13, 17-21 (C.A. 9th). Taxpayers, without objection by the Commissioner, allocated $228,077.95 of the price to a group of assets that they treated as the equivalent of cash, leaving $661,537.32 as the cost of the remaining assets.

:71, 275-276; Commissioner v. American Liberty Oil Co., 127 F. 2d 52, 264 (C.A. 5th); Blum v. Commissioner, 5 T.C. 702, 709). This llocation of the total cost among the several assets is made in ccordance with their relative fair market values as of the time of he acquisition. Harber Plywood Co. v. Commissioner, 143 F. 2d 780, 83 (C.A. 9th); United States v. Mattison, 273 F. 2d 13, 21 (C.A. th); Commissioner v. American Liberty Oil Co., supra, 127 F. 2d,). 624. Taxpayers argue, however, that the Tax Court erred in deter-ining that they recognized gain of $101,572 in connection with their sale of the unmatured lemon crop. This argument is based on their contentions: (1) that where, as here, a portion of the assets are sold immediately upon acquisition no gain is to be recognized with respect to that sale, and (2) that in any event the fair market value of all of the acquired assets was only $661,537.32. We submit that there is no merit to either of taxpayers' contentions and that the Tax Court's determination that they recognized gain in the amount of $101,572 with respect to the sale of the lemon crop is correct.

A. The price paid for the lemon orchard, the unmatured lemon crop and the related assets was properly allocated to those assets in accordance with their fair market values

In attempting to avoid the application here of the rule that the price paid for a group of assets must be apportioned among them on the basis of their relative fair market values and that gain or loss must be recognized upon a disposition of any of these assets, taxpayers seek to create an exception for a situation where the purchase includes

both fixed assets and current assets and where some of the current assets are sold immediately following the purchase. Taxpayers argue that in such a situation the price paid for the group of assets should be allocated first to the current assets to the extent of their full fair market values, with only the remaining cost allocated to the other assets, which will result in the nonrecognition of gain with respect to the disposition of the current assets. The reason given by taxpayers for their contention as to the impropriety of uniformly allocating purchase price to the current and fixed assets of a going business on the basis of their relative fair market values is that the value of the fixed assets to the buyer of the business depends on the extent to which the future operations of the business will be profitable. Because of this uncertainty with respect to the future success of the business the buyer should, according to taxpayers, be permitted to recoup on a tax-free basis, through the disposition of the current assets, as great a portion of the price paid for the business as the amount of its current assets will permit, which result will obtain if the buyer is permitted to make a first allocation of cost to the current assets. Thus, taxpayers' argument is that they should not be required to recognize income with respect to the sale of one of the purchased assets when there was a possibility that the complete venture, i.e. the purchase of the Del Norte assets, would not have been a profitable one. This argument, however, is without merit and must be rejected, for it is in direct conflict with the annual accounting theory, which subjects to tax the gains of particular periods, regardles

of the fact that the entire venture may turn out to be an unprofitable one. Burnet v. Sanford & Brooks Co., supra; Heiner v. Mellon, supra.

Taxpayers also argue, alternatively, that since the unmatured lemon crop was immediately sold it was a "cash equivalent" and was therefore entitled to first allocation of cost to the extent of its fair market value. The Tax Court has held, in cases where cash and assets constituting the immediate right to receive cash were acquired together with other assets in a lump sum purchase, that the price paid was to be allocated first to the cash and immediate rights to receive cash to the extent of their face amounts, with the remaining cost allocated to the other assets in accordance with their fair market values. Graves v. Commissioner, decided May 14, 1952 (P-H Memo T.C., par. 52,143); Bessemer Limestone and Cement Co. v. Commissioner, decided November 23, 1956 (P-H Memo T.C., par. 56,250). The unmatured lemon crop did not, however, like a bank deposit or the cash surrender value of insurance, constitute a right to receive cash. Certainly an asset is not "equivalent to cash" merely because it is saleable and is in fact sold; for on this basis even a portion of the land acquired would have been a "cash equivalent" if taxpayers had immediately sold it. But more significantly, the rationale underlying the first allocation of cost to cash and the immediate right to receive cash -- that one will ordinarily not sell cash or the immediate right to receive cash at a discount, since he can obtain the benefit of one hundred percent of its value simply by retaining it, and that therefore the purchaser will have paid its full face

amount for it (cf. Williams v. McGowan, 152 F. 2d 570, 572 (C.A. 2d)) -- is inapplicable to the lemon crop. While the lemon crop had a fair market value of $237,700 as of September, 1953, it was certainly not equivalent to that amount of cash in the hands of the Del Norte Citrus Company, from whom taxpayers acquired it. Assuming that it would have been feasible for Del Norte to sell the crop before its stock was sold to taxpayers, [4] the proceeds of the sale would have been taxed to the corporation as ordinary income. Watson v. Commissioner, 345 U.S. 544, 551-552. During 1953, the year here in issue, the corporation's ordinary income was subject to federal income tax at the rate of 30 percent of the first $25,000 and 52 percent of the excess (see Internal Revenue Code of 1939, Sections 13(b)(2) and 15(b), as amended by Sections 121(a) and (f), Revenue Act of 1951, c. 521, 65 Stat 452) and to state franchise tax at the rate of 4 percent (see 3 Deering's California Revenue and Taxation Code, Annotated, Section 23151). Thus, the net amount of cash that the corporation would have derived upon the sale of the crop would have been substantially less than $237,700. Under these circumstances the Del Norte shareholders would not expect to receive and taxpayers would certainly not pay them $237,700 with respect to the lemon crop. Clearly, the lemon crop was in no respect a "cash equivalent".

4/ The sale by taxpayers of the unmatured lemon crop required an agreement by them to maintain the lemon orchard in good and healthy production during the period when the crop would be on the trees. (I-R. 37, 38.) There has been no showing that one about to dispose of a lemon orchard would be willing to assume the liability that would arise under such an agreement in the event that the purchaser of the orchard failed to so maintain it.

None of the cases cited by taxpayers support their contention that the lemon crop was entitled to first allocation of cost so that no gain was to be recognized upon the sale of the crop. The eight cases cited by taxpayers at the bottom of page 26 and the top of page 27 of their brief [5/] did not involve the question of allocation of cost to current assets and the recognition of gain with respect to the disposition of such assets. In these cases the Commissioner had simply not disturbed the taxpayers' allocation of cost with respect to the relatively insignificant amounts of current assets, which, in a number of the cases, was based on the allocation of the purchase price that the parties had agreed to in the contract of sale. In a case where the court did consider this question, Graves v. Commissioner, supra, cited by taxpayers (Br. 29), it permitted a first allocation of cost only with respect to cash and immediate rights to receive cash, i.e. the cash surrender value of insurance policies and the funds that were immediately withdrawable from an account with a factoring company. On the other hand, the court did not permit a first allocation of cost even with respect to items of inventory and supplies that were returned to the original vendors for credit or to ordinary accounts receivable. In Bessemer Limestone and Cement Co. v. Commissioner, supra, cited by taxpayers (Br. 30), a first allocation

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5/ American Fork & Hoe Co. v. Commissioner, decided September 22, 1943 (P-H Memo T.C., par. 43,431); Philadelphia Steel & Iron Corp. v. Commissioner, decided April 13, 1964 (P-H Memo T.C., par. 64,093), affirmed per curiam, 344 F. 2d 964 (C.A. 3d); Estate of Suter v. Commissioner, 29 T.C. 244, acquiescence, 1958-2 Cum. Bull. 8; Zemmer v. Commissioner, decided May 15, 1963 (P-H Memo T.C., par. 63,131); Fox & Hounds, Inc. v. Commissioner, decided September 27, 1962 (P-H Memo T.C., par. 62,229); Herbert v. United States (S.D. Calif), decided November 7, 1961 (8 A.F.T.R. 2d 5824); Alper v. Commissioner, decided

of cost was permitted only with respect to "cash and its equivalents"; the court did not even suggest that anything other than cash and the immediate right to receive cash came within this category. Similarly, in F. & D. Rentals, Inc. v. Commissioner, 44 T.C. 335, on appeal to the Court of Appeals for the Seventh Circuit, where the Commissioner did not disturb the taxpayer's allocation of cost to the current assets 6/ other than inventories, the court held that neither the finished goods nor the other inventories were the equivalent of cash and, as such, entitled to first allocation of cost and that since the taxpayer had failed to show the fair market value of the inventories, so as to permit an allocation of cost in accordance with fair market values, and had not shown that the Commissioner's allocation of cost to the inventories was unreasonable, the Commissioner's allocation would be sustained. In Apex Brewing Co. v. Commissioner, 40 B.T.A. 1110, acquiescence, 1940-1 Cum. Bull. 1, the Commissioner sought to allocate the purchase price of a brewery among the acquired assets in accordance with their original costs to the seller. The taxpayer did not show the value of the fixed assets, beyond a showing that a substantial portion of these assets were obsolescent and inferior.

5/ (contd.) February 27, 1962 (P-H Memo T.C., par. 62,038); Farmers Cotton Oil Co. v. Commissioner, 27 B.T.A. 105, non-acquiescence XII-1 Cum. Bull. 16 (1933).

6/ With the exception of the inventories, the only current assets of any significance acquired by the taxpayer were accounts receivable, the collection of which was guaranteed by the seller. Since none of the risk of noncollection of these receivables was shifted from the sellers to the taxpayer, the portion of the purchase price attributable to these receivables could not have been substantially less than their face amount.

it did show that the seller of the brewery had offered to repurchase the beer at $7 per barrel and that the inventory value of the beer to it, based on its actual sales, was $6 per barrel, which value was more than 2-1/3 times greater than the amount allocated to the beer inventory by the Commissioner. The court, having rejected the Commissioner's allocation, which was based on the original costs to the seller, on these facts permitted cost of $6 per barrel to be allocated to the beer inventory, with the balance of cost to be allocated to the other assets. Regardless of the correctness of this decision, it is apparent that it does not hold that where the fair market values of all of the acquired assets are known a first allocation of cost is to be made to assets other than cash and the immediate right to receive cash.

O.D. 714, 3 Cum. Bull. 49 (1920), cited by taxpayers (Br. 24-25), sets forth the rule that where a taxpayer purchases land on which an unmatured crop is growing and later sells the crop, the income to be recognized by him upon the sale of the crop is not the full amount received for the crop, as would be the case had the land not been purchased during that crop year, but only the excess of the net selling price of the crop over its cost. Cf. Triple E. Development Co. v. Commissioner, 20 T.C. 619. The statement in the O.D. that in the absence of an assignment of part of the purchase price to the crop, gain or loss is to be determined on the basis of the fair market value of the crop necessarily assumes that there is no showing that the price paid for the land and the

crop was less than their fair market values. If, as taxpayers contend, the O.D. purported to permit them to offset the fair market value of the crop against its selling price even though the cost of the crop to them was less than its fair market value, 7/ and to thus not recognize for tax purposes the gain that they had realized on the disposition of the crop, it would be contrary to the annual accounting principle underlying the federal tax system (Heiner v. Mellon, supra), and being a wholly incorrect statement of the law would not bar the Commissioner from applying the correct legal principle (Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 183-186, rehearing denied, 353 U.S. 989; Dixon v. United States, 381 U.S. 68, 70-76; Time Oil Co. v. Commissioner, 294 F. 2d 667, 672-673 (C.A. 9th), concurring opinion of Judge Stephens).

Taxpayers incorrectly state (Br. 21) that the loss resulting from the sale of an asset that has just been acquired in a lump-sum purchase of a group of assets is not deductible. The regulation (Treasury Regulations on Income Tax (1954 Code), Section 1.61-6(a)) providing for the recognition of gain or loss upon the disposition of such an asset does not exclude a disposition that follows immediately after the purchase. None of the cases cited by taxpayers (Br. 21) support their statement. In Tube Bar, Inc. v. Commissioner,

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7/ Contrary to taxpayers' statement (Br. 25), other taxpayers have recognized that the purchase price of an orchard is to be allocated among all of the acquired assets including the unmatured crop accordi[ng] to their fair market values, where the total of these fair market values exceed the purchase price. See Edwards v. Commissioner, decided October 28, 1953 (P-H Memo T.C., par. 53,344).

15 T.C. 922, the taxpayer purchased a tavern in order to obtain its liquor license, which was to be transferred to another location, and then sold the tavern, without the license, for $2,900 less than it had paid. The court correctly held that the excess of the price that taxpayer paid over the amount that it received constituted the cost of the license, which it had retained, and was not deductible. In N. W. Ayer & Son, Inc. v. Commissioner, 17 T.C. 631, acquiescence, 1952-1 Cum. Bull. 1, and Hillside National Bank v. Commissioner, 35 T.C. 879, the court held that where improved real estate is purchased with the intention of removing the improvements thereon in order to use the land all of the purchase price, as increased by the cost of demolishing or removing the improvements and as decreased by amounts received upon the sale of any improvements salvaged from the property, is allocable to the land. Since, in such a situation, the value, if any, of the improvements that are to be removed or demolished is limited to what can be obtained from their salvage and is unrelated to the value that they would have if they were to remain and be used on the property, allocation to the improvements of a portion of the purchase price equal to the latter value would clearly be incorrect. This does not mean, however, that where property is purchased with the intention of immediately selling a part of it, the purchase price should not be allocated to the various parts in accordance with their fair market values as separate assets, and gain or loss recognized upon the sale. In McGregor v. Commissioner, decided August 9, 1955 (P-H Memo T.C., par. 55,223),

cited by taxpayers (Br. 27), the court stated the rule that where a lump-sum consideration is paid for a conglomeration of assets the cost of each asset is to be determined by apportioning the purchase price among the assets on the basis of their relative fair market values at the time of acquisition and then simply held that taxpayers had failed to show that the portion of the price paid for the farm that would be so allocable to the crop was greater than the amount that had been allocated to it by the Commissioner.

In the instant case, since the fair market values of the assets acquired exceeded the lump-sum purchase price, the cost of one of these assets, i.e. the lemon crop, was properly determined by apportioning the purchase price among the assets on the basis of their relative fair market values at the time of purchase. The excess of the price received by taxpayers upon their sale of the crop over its cost to them, as so determined, constituted taxable gain to them in the year of the sale.

B. The Tax Court's findings with respect to the fair market values of the assets that were acquired by taxpayers are correct

The Tax Court did not fully accept either the opinion of the Commissioner's appraiser or the opinion of taxpayers' appraiser as to the fair market value of the Del Norte assets at the time of their acquisition by taxpayers; but after considering the reports of both of these appraisers and the testimony of the Commissioner's appraiser, who testified at the trial as an expert witness,[8/]

8/ The taxpayers did not call their appraiser to testify.

determined that the total of the fair market values of the assets, other than the unmatured lemon crop, which was valued at $212,700, was $823,300.[9/] This finding has substantial basis in the evidence and certainly cannot be said to be clearly erroneous. Accordingly, this finding must stand. Palmer v. Commissioner, 302 U.S. 63, 70; Williams' Estate v. Commissioner, 256 F. 2d 217, 220 (C.A. 9th); Tripp v. Commissioner, 337 F. 2d 432, 434 (C.A. 7th).

Contrary to taxpayers' contention (Br. 17, 22-23), the Tax Court did not misinterpret the appraisal report of Sherman Taschner, the taxpayers' appraiser. Taxpayers do not dispute the correctness of the Tax Court's statement (I-R. 55) that, with the exception of the value assigned to the lemon trees,[10/] there were no substantial differences between the fair market values assigned to each of the various acquired assets by taxpayers' and the Commissioner's appraisers. Taxpayers argue, however, that the Tax Court erred in considering the fair market values placed upon the various assets by their own appraiser, because of the last four paragraphs of his report, which they quote (Br. 16-17), wherein he states that notwithstanding his own opinion as to the fair market value of each of the various

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9/ This does not include the value of those acquired assets to which taxpayers, without objection by the Commissioner, allocated $228,077.95 of the total cost. See fn. 3, supra.

10/ The Tax Court accepted the lower value that had been assigned to the lemon trees by the Commissioner's appraiser since that value did not include the unmatured lemon crop, which the court valued separately. (I-R. 55.) The court also accepted the lower value that had been assigned to the land by taxpayers' appraiser. (I-R. 56.)

assets acquired by the taxpayers, the fair market value of the lemon orchard with the related assets could not exceed the total purchase price less the amount that was received upon the sale of the lemon crop. This statement by taxpayers' appraiser -- which merely repeats in slightly different form taxpayers' basic contention upon this review, that no gain was realized upon the sale of the lemon crop -- is both incorrect and irrelevant. This statement is based on the assumption that the lemon crop was equivalent to cash, so that the portion of the purchase price attributable to it was equal to its fair market value, an assumption which, as we have shown, pp. 15-16, supra, is incorrect. 11/ Moreover, in focusing on this statement by their appraiser, taxpayers indicate an apparent misunderstanding on their parts as to the purpose of the allocation of a lump-sum purchase price. Where a group of assets is purchased for a lump-sum price it is necessary to allocate a portion of the price to each of the acquired assets in order to determine the cost of each of them, since the depreciation on a depreciable asset as well as the gain or loss upon the disposition of an asset depends on the cost of that asset. In such a situation, the cost of each of the assets is determined by apportioning the purchase price among them on the basis of their relative fair market values. Accordingly, in

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11/ The testimony of Alvin Herron, taxpayers' accountant (II-R. 571-572), cited by taxpayers (Br. 30), is based on the same incorrect assumption. Even if his testimony was a correct statement of the proper accounting practice to be followed in such a situation, it wou however, be irrelevant, since the recognition of gain for tax purpose does not depend on how the transaction would be treated under commercial accounting standards. See Schlude v. Commissioner, 372 U.S. 128 cf. Lucas v. American Code Co., 280 U.S. 445, 452.

determining the cost of the lemon crop the Tax Court apportioned the purchase price among the acquired assets, i.e. the land, the trees, the buildings, the equipment and the unmatured lemon crop on the basis of their relative fair market values,[12/] as to which, with the exception of the value of the trees, the appraisers were in substantial agreement. That the fair market value of the assets other than the lemon crop, if taken together, might have been less than the total of their individual fair market values would be relevant only if taxpayers were required to recognize gain with respect to the purchase of these assets, which they are not. It would be irrelevant here, where the sole significance of the fair market values of the acquired assets is that they serve as the basis for apportionment of the purchase price.

12/ Since, in this portion of its opinion, the Tax Court was determining only the cost of the lemon crop, it was able to accomplish this by simply adding together the fair market values of the assets other than the lemon crop and then apportioning the purchase price between that total and the fair market value of the lemon crop. (I-R. 56.)

CONCLUSION

The Tax Court's determination that taxpayers recognized gain of $101,572 upon the disposition of the lemon crop is correct and should be affirmed.

Respectfully submitted,

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CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated this ______ day of May, 1966.

____
Attorney